

UNUSUAL MARKET ACTIVITY: THE SEC AND HIGH FREQUENCY TRADING

U.S. Senator Ted Kaufman

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Mr. President, last Thursday, for one of the few times since 24 stock brokers first gathered under a buttonwood tree in 1792, we had a stock market that for 20 minutes stopped performing its essential function: discovering the prices of securities based on a balance between buyers and sellers.

Our equity markets collapsed in a matter of minutes. Liquidity dried up, a deluge of sell orders overwhelmed buyers, and the rug was pulled out from underneath millions of investors, plummeting the Dow Jones Industrial Average toward its biggest intraday loss in history, nearly 1,000 points.

Then, just as quickly and inexplicably, the market reversed course, snapping back like a yo-yo and recovering much of its lost ground.

In the immediate aftermath, the world's focus turned to black-box computer trading, which relies upon electronic trading algorithms to execute thousands of orders in tiny fractions of a second.

These high-frequency-trading computer programs determine, with minimal human intervention, the timing, price and quantity of orders.

Mr. President, it's too soon to know the myriad factors that played into last week's meltdown, though it appears to be quite likely that we witnessed a real-time example of high-tech trading run wild – or, in some cases, unplugged.

The cooperation between the SEC and CFTC is critical to unraveling what happened in the futures and equities markets, and we should wait for their investigation and for all the facts to be discovered.

It also is too soon to coalesce around band-aid solutions – that is, without also committing to dive deeper into the structural problems and inherent conflicts of interest that are part of our capital markets.

The SEC still has not discovered or explained what triggered or accelerated the incident, but already the leaders of the exchanges have admitted that no one had previously thought to implement system-wide circuit breakers or adequately protect against the possibility of erroneous trades.

Yesterday, after meeting with the leaders of six exchanges, the SEC released a statement saying:

“As a first step, the parties agreed on a structural framework, to be refined over the next day, for strengthening circuit breakers and handling erroneous trades.”

Mr. President, that is fine. But it is indeed only “a first step,” however belated.

While it is true that we must wait for the information to come in before we reach any conclusions, there are many questions that must be carefully reviewed and answered.

The first and most obvious is whether we have gone from too few market centers – when just the New York Stock Exchange and Nasdaq were a duopoly – to too many, each with different standards and procedures for protecting investors and preserving market integrity?

We now have more than 50 market centers, which has brought added competition. Today, algorithmic trading interests are wired across markets – equity, fixed income, futures and options; the market is the network - and yet our regulators work in silos. Responsibilities are divided between the SEC and CFTC. Within equities markets, we have multiple Self Regulatory Organizations setting rules – more silos: New York Stock Exchange, NASDAQ, FINRA, National Stock Exchange, and more. All too often, those rules have been watered down and eliminated in the absence of the SEC establishing these and other regulatory controls across equity markets. We created a "National Market System" but we forgot to create a "National Regulatory and Surveillance System" to go along with it.

We need a consolidated audit trail across all market centers, as Senator Schumer and others have raised. As FINRA Chairman Rick Ketchum admitted last October, regulators are looking at “an incomplete picture of the market and knowing full well that this fractured approach does not work.”

The second obvious question is: Why is it taking the SEC so long to reconstruct the unusual market activity of last Thursday?

Because there is no transparency. The Commission does not yet collect by rule the data it needs efficiently to reconstruct unusual market activity. Even though Congress gave the SEC “large trader” reporting authority in the Market Reform Act of 1990 – after the SEC had difficulty in reconstructing market incidents in 1987 and 1989 – the SEC never used it. The SEC proposed a large trader rule in 1991, received comments, re-proposed it in 1994, and then never adopted it. This is even though the Commission acknowledges: “the current Electronic Blue Sheet system does not efficiently collect large volumes of data in a timely manner that allows the Commission to perform contemporaneous analysis of market events. Further, the data generated by the EBS system does not include important information on the time of the trade or the identity of the customer.”

Flash forward to 2009. To SEC Chairman Mary Schapiro’s credit, she began a process of studying market structure and high frequency trading last October.

I have to say, however, the pace of the Commission's progress has been slow. Indeed, as many of my colleagues know, I have come to the floor repeatedly to call for a greater sense of urgency at the Commission.

For example, last year on September 23rd, I spoke on the Senate floor and asked about high frequency trading strategies:

“Do these high-tech practices and their ballooning daily volumes pose a systemic risk?”

“What do we really know about the cumulative effect of all these changes on the stability of our capital markets?”

“In order to maximize speed of execution, many sponsored access participants may neglect important pre-trade credit and compliance checks that ensure faulty algorithms cannot send out erroneous trades.”

On November 20th, 2009, I wrote a letter to SEC Chairman Mary Schapiro asserting:

“[T]ransparency, disclosure and risk compliance requirements on the trading activities of high frequency traders are needed urgently. And while I was encouraged to hear that the Commission may move sooner with its existing authority to require ‘tagging’ and reporting by ‘large traders’ now using high-frequency algorithms, I am concerned that the Commission does not intend to issue a concept release on high frequency trading until early next year, and that rule proposals should not be expected before the summer of 2010. Given that the Commission under current procedures is now blind to high frequency operations, the need for immediate action should not wait until the Commission has completed its comprehensive review.”

In her response on December 3, Chairman Schapiro assured me the Commission was planning to issue a proposed “large trader” tagging rule the following month.

But it was not until months later, on April 14th, that the Commission finally did so. Mr. President, while I understand the many hurdles regulatory agencies face which slow them down — in particular the need to avoid unintended consequences — this process was clearly way beyond deliberative.

Given the deficiencies in the current data collection system that the SEC itself acknowledges and which Congress gave the SEC the authority to address in 1990, this delay is inexcusable.

The SEC must move aggressively to finalize the large trader rule and insist on fast-track implementation by the industry.

There are many other questions a deeper review should study.

Particularly the problem of high frequency programs which sell stock short without first locating the underlying shares or borrowing them in hope that their price will drop and they can buy those shares back – before the required delivery date – at a lower price for a profit. Last Thursday, it appears that the computers went into overdrive spewing out sell orders, and in the critical 10 minute time period, I'll bet my bottom dollar that many of those sell orders were short sales that did not first locate the stock.

Now as I've said repeatedly, there's nothing wrong with short selling, I've done it myself. But I've always had to borrow the stock first.

Last July, along with Senator Johnny Isakson (R-GA) and six other Senators, we wrote the SEC demanding that short sales not be permitted unless the seller first obtains a "hard locate" of specified shares. But that proposal went nowhere, even though the SEC held a Roundtable last September to discuss the problems associated with naked short selling.

The larger point is these high frequency trading firms have assumed the role that specialists used to take. Some of them get the same benefits of specialists. They get to ignore short-selling locate rules. They get to step in front of other orders on the book legally. All because they provide liquidity, for which they are also paid.

Why should they have those advantages? Did some of them abandon their role of liquidity provider when the market needed them most, and instead use their advantages to disadvantage everyone else on the way down? Those questions must be answered.

Last September 14th I went to the Senate floor and spoke about the dangers of unregulated high-frequency trading, asking:

"If we experience another shock to the financial system, will this new, and dominant, type of pseudo market maker act in the interest of the markets when we really need them?

Will they step up and maintain a two-sided market, or will they simply shut off the machines and walk away?

Even worse, will they seek even further profit and exacerbate the downside?"

After Thursday's plunge, I am afraid my questions have been answered.

Instead of providing "fair and orderly markets" as some market makers are obligated to do, some of these unregulated players may have added to the chaos, while others simply unplugged their computers and suspended operations, reducing liquidity when the market needed it the most.

Here is another related question: Was there manipulation involved on Thursday? More to the point, does the SEC even have the ability to detect illegal manipulation by high frequency algorithms?

Well we know the SEC doesn't have the data it needs. The large trader rule hopefully will fix that at some future date.

There is also the question of whether the SEC has the internal analytical capability to use that data to police trading activities?

I have been suggesting that once the SEC collects the data, it should mask the proprietary nature of the data and either (1) release it to the marketplace, or (2) to academics and private analytic firms under "hold confidential" agreements. I believe the SEC needs help in conducting analyses about whether high frequency trading practices are harmful to the interests of long-term investors.

Another question I have raised in the past is whether the SEC needs to impose industry-wide pre-trade operational risk controls, in order to prevent the incidence and magnitude of trading errors and the havoc they can cause.

After last Thursday, that one is starting to look easy.

Markets have always had operational risks, but it is clear that the proliferation of competing complex computer models has the potential to magnify and exacerbate these risks in ways that can fundamentally damage market integrity and confidence.

With computerized, high-frequency trading now responsible for an estimated 70 percent of daily trading volume, markets have come to rely upon these black-box systems for ample and consistent order flow.

Yet, humans are simply unable to evaluate in real-time whether their trading models are working as intended.

Yet another question, Mr. President, is whether our markets are still performing one of their best and most important functions: the constant and reliable channeling of capital through the public sale of company stock known as Initial Public Offerings. According to a series of reports released last year by the accounting firm Grant Thornton, the answer is no, the IPO market in the United States "has practically disappeared."

Without a doubt, there have been many causes of the sad state of America's IPO market. But one source of the problem might be the dominance of high frequency trading strategies designed to trade in the most-active, highly-liquid names, but with little support for small-cap stocks.

Our markets should work to best serve Americans – by reflecting changes in supply and demand and investors' assessments of stock fundamentals – not by encouraging a battle between algorithms looking to shave microseconds from their transactions in a few highly liquid names. As Dallas Mavericks' owner and long-time investor Mark Cuban

has recently asked: “What business is Wall Street in? ... [I]t is important for this country to push Wall Street back to the business of creating capital for businesses.”

There are other questions, as well, Mr. President, many involving conflicts of interest and the failures of some of the exchanges and market centers to fulfill their gatekeeper function as self-regulatory organizations.

Moving forward, I applaud Senator Dodd, the Chairman of the Banking Committee, for calling for hearings to be chaired by Senator Jack Reed on the market’s recent plunge and recovery.

And I am also pleased that a number of market participants and regulators have recognized the need for regulations that will protect the markets from future periods of extreme and inexplicable volatility.

I am concerned, however, that the SEC must not solely look for quick fixes and surface solutions. The events of May 6th call for a meaningful review of these structural issues, leading to reforms that truly protect investors and restore the credibility of our markets so they serve well their highest and best function.

That is why Congress, consistent with its oversight responsibilities, must direct regulators to study and report, in a timely manner, on what needs to be done to prevent another meltdown of this magnitude. It is entirely appropriate for Congress to elaborate on the needed elements of a meaningful review, many of which I have outlined today.

Mr. President, Senator Mark Warner and I want to add language to the current Wall Street Reform Act that would do just that. Once that report to Congress is finished, only then can Congress either draft needed legislation or encourage new rules.

We all know that the challenge for regulators is to see beyond the horizon and to act preventively before financial crises hit.

This is always difficult, but especially so when markets are opaque and Wall Street interests resist even reasonable suggestions about needed reforms.

During the past nine months, in response to my calls for transparency and an SEC review of high frequency trading, many voices on Wall Street praised the virtues of electronic trading -- and almost none were interested in looking critically or even honestly for weaknesses or potential systemic risks.

Mr. President, my staff has read through nearly a hundred comment letters submitted over a period of months from brokerage firms, consultants, exchanges, high frequency firms, and alternative trading systems. The vast, vast majority of those letters stated the markets have performed exceptionally, and just needed to be left alone. They all stated how things were fine and saw nothing amiss. Systemic risk? Not here.

Our exchanges – which by statute are required to “prevent fraudulent and manipulative acts and practices” and be the first line of regulatory review of trading practices –are now competing vigorously to attract high volume traders to maintain their profits. Yet in response to the SEC’s concept release raising questions about market structure issues, sources of systemic risk and possible manipulation by high frequency traders, the CEO of BATS Exchange sent out a “call to action” for all high frequency trading firms, suggesting that they all file comment letters on common themes. “The best defense is a good offense,” he wrote.

His letter also said, and I quote: “BATS doesn’t believe the equities markets are broken. To the contrary, we would argue that the US equity markets were a shining model of reliability and healthy function during what some are calling one of the most challenging and difficult times in recent market history.”

He went on to write, “Those outside the industry, who have differing opinions, are likely to have a difficult time bringing forward compelling arguments based on the lack of hard evidence.” I ask: Is this the attitude we want from those charged with protecting investors?

Yes, when the markets are opaque and no one outside the industry has any data, when the exchange leadership itself stays on offense, it is indeed difficult to offer hard evidence supporting a contrary view.

And let me read from a comment letter to the SEC written by the Security Traders Association in the week before the meltdown:

“The equity markets are functioning properly, and there are no signs of significant deficiencies or an inability to perform their important functions.”

Saying it does not make it so, Mr. President. And now, the credibility of both markets is urgently in need of repair.

But for that to happen, democracy must work in a way that permits timely reform of our most powerful financial institutions. And Wall Street must recognize its own long-term interests – the credibility of our markets – are vitally at stake.

Mr. President, I will close my remarks today with the same words I used to conclude my floor speech last September 23, as they still ring true:

“We cannot simply react to problems after they have occurred. We need the information and resources to identify problems before they arise and stop them in their tracks...[W]e cannot allow liquidity to trump transparency and fairness, and we cannot permit the need for speed to blind us to the potentially devastating risks inherent in effectively unregulated transactions.”

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